No. 775

In the Supreme Court of the United States

OCTOBER TERM, 1941

WILMINGTON TRUST COMPANY, EXECUTOR OF ALICE DUPONT ORTIZ, DECEASED, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 1–23) is reported in 42 B. T. A. 173. The opinion of the Circuit Court of Appeals (R. 87–94) is not yet reported.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on September 3, 1941 (R. 94). The petition for a writ of certiorari was filed on No-

vember 29, 1941. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Where the taxpayer had long and short accounts in the same stocks with a brokerage firm, may the dividends charged against the taxpayer in her short account be offset against the dividends credited to the taxpayer in her long accounts? This depends upon (a) whether the sales in her short account were intended to be and actually were executed as short sales; and if they were short sales, upon (b) whether the taxpayer was engaged in carrying on a "trade or business" within the meaning of Section 23 (a) of the Revenue Act of 1934; and if she were engaged in business within the meaning of the statute, upon (c) whether the dividends charged against the taxpayer on account of the short sales were "ordinary and necessary" expenses of the business within the meaning of the statute.

2. If the taxpayer were engaged in business within the meaning of Section 23 (a), whether commissions paid to brokers for sales of stocks and commodities in the circumstances of this case constitute ordinary and necessary expenses of the business within the meaning of the statute.

STATUTE INVOLVED

Revenue Act of 1934, c. 277, 48 Stat. 680:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> (a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *
>
> * * * * * * *

(U. S. C., Title 26, Sec. 23).

STATEMENT

The facts, as stipulated (R. 25–35)[1] and as found by the Board of Tax Appeals (R. 2–12), may be summarized as follows:

The taxpayers were husband and wife living in Delaware and filed joint income tax returns for the years 1934 and 1935 on a cash receipts and disbursements basis. Since the husband had allowable deductions in excess of his gross income for 1934 and no income or deductions for 1935, we will refer to the wife as the taxpayer[2] (R. 2).

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[1] The exhibits, attached to the stipulation of facts, have not been included in the printed record, but may be found in the original transcript which has been transmitted to this Court by the Clerk of the Circuit Court of Appeals. See pages 38 to 547.

[2] After the decision of the Board, the taxpayer died. Upon Suggestion of Death her executor was ordered to appear and designate counsel, whereupon her executor complied with the court's order (R. 79–81, 86).

The taxpayer maintained several brokerage accounts with a firm in Wilmington, Delaware, which will be referred to as the regular, special, and short accounts (R. 3). During the year 1934 the taxpayer's regular and special accounts were credited with dividends in the aggregate amount of about $146,000. During the same year her short account was charged with dividends in the aggregate amount of about $145,000. During the year 1935 the taxpayer's regular and special accounts were credited with dividends in the aggregate amount of about $23,000; and during the same year her short account was charged with dividends in the aggregate amount of about $25,000 (R. 5–6).

The taxpayer did not return the dividends credited as gross income, although the brokerage firm reported them to the Treasury Department as dividends received on stocks owned by the taxpayer (R. 7).

The taxpayer, a housewife, had an office at her home where she employed a broker's customer's man as secretary and bookkeeper, and where she spent an average of an hour a day. At that office she studied stock market reports and periodicals and presumably on the basis of these studies bought and sold large blocks of stock. The purchases and sales amounted to over 338,000 shares in 1932; 101,000 shares in 1933; 33,635 shares in 1934; and 53,000 shares in 1935 (R. 9–11).

The Board of Tax Appeals held that the dividends charged against the taxpayer in her short account should be offset against the dividends credited the taxpayer in her long accounts, because the short sales were intended to be and actually were executed as ordinary sales (R. 16). The Board further held, in the alternative, that if it were wrong in failing to hold the sales to be short sales, the taxpayer was engaged in the business of buying and selling stocks and that the dividends charged were ordinary and necessary expenses of that business; it also held that the commissions on sales were deductible as ordinary and necessary expenses of the taxpayer's business (R. 16–17).

The court below reversed and held that the short sales were intended to be and actually were short sales; that the taxpayer was not engaged in business under the rule laid down by this Court in several recent cases, and that in view of the court's holding that taxpayer was not engaged in business, it was not necessary to decide whether the commissions on sales or commodities were ordinary and necessary expenses of a business.

ARGUMENT

1. The taxpayer maintained long and short accounts in the same stocks,[3] and the question presented is whether she was entitled to offset the

[3] The advantages of selling short while one has long stock which one might deliver against the sale is that it avoids taking profits and thus postpones the tax, and that it en-

dividends payable by her in her short account against the dividends received by her in her long account. The Government contended that such offset is not allowable, since the taxpayer had maintained two separate accounts, with the consequence that the dividends received by her in the long account must be included in gross income, whereas the dividends paid by her with respect to the short account were not deductible as ordinary and necessary business expenses under Section 23 (a) of the Revenue Act of 1934. The taxpayer contended, and the Board held, that she had not made short sales at all and that her tax liability must be computed as though she had merely made long sales, thus reducing the number of shares upon which she was obligated to report dividends as gross income. The Board also held that even if the taxpayer had made short sales the dividends paid by her on the short accounts were, nevertheless, deductible from gross income as business expenses. The court below reversed, holding (1) that the sales were short sales and (2) that the dividends were not deductible business expenses.

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ables one to cover the sale with long stock if the market goes up or to cover with new purchases if the market goes down. Prior to June 1932 there was the additional advantage of using the "capital gain" rate if the taxpayer covered the short sale with stock that had been held for more than two years. In 1932, however, the Revenue Act was amended so as to treat gains and losses from short sales as ordinary gains and losses.

In reversing the ruling of the Board that the taxpayer had not made short sales, the court below reexamined, as it had a right to do, the legal effect of the taxpayer's transactions. Cf. *Helvering* v. *Tex-Penn Co.*, 300 U. S. 481, 491; *United States* v. *Pyne*, 313 U. S. 127. And that such transactions are to be treated as the legal equivalent of short sales is fairly inferable from two decisions in which similar transactions were executed in the same manner by the same brokerage firm as is involved herein. *Henry B. duPont* v. *Commissioner*, 98 F. (2d) 459 (C. C. A. 3d), certiorari denied, 305 U. S. 631; *Henry F. duPont* v. *Commissioner*, 110 F. (2d) 641 (C. C. A. 3d), certiorari denied, 311 U. S. 657.

We submit that the decision below was correct, irrespective of whether the broker purported to make deliveries on the taxpayer's short sales from securities held in her long account. None of the securities were held in her name; they were all in street names, and it is meaningless to assert that the broker made deliveries from her long holdings to cover her short sales. The plain fact is that no certificates whatever stood in her name and that the broker maintained long and short accounts on her behalf, charging her with interest, dividends, etc., as would be appropriate to such accounts. The testimony of the broker's employees, relied upon by the Board, even if accepted at face, should have no legal significance in the circumstances.

In any event, however, the purported findings of the Board upon the basis of that testimony were inconsistent with its other findings and therefore were properly reexamined by the court below.

The Customer's Ledgers for the taxpayer's various accounts are exhibits attached to the Stipulation of Facts and are expressly incorporated in the Board's findings (R. 2). These include the Customer's Ledger for the taxpayer's short account during the taxable years (Exhibit K, Tr. 228), which shows the various dividends charged against the short account, the number of shares of the various stocks short each month, and the credit balance at the end of each month. Moreover, the Board's findings expressly show that the taxpayer was charged with dividends against the short stock during the taxable years (R. 6). The taxpayer's personal records correspond to the broker's records as to the number of shares short in the various stocks and the dividends charged against her short account, and show that she entered a profit or loss *when she covered the short sale, not at the time of the sale.* The court below said (R. 88):

> Quite clearly taxpayer treated the sales as short sales. The transactions were so entered upon her books. Gains or losses were not reported at the moment of sales, as would be done if a long sale were contemplated. Instead the profit or loss entry

was not made until the covering transaction was completed. The certificates of stock actually used were in no way designated as belonging to taxpayer. Where dispositions of long stock occur, the proceeds are credited to the seller and are immediately available without restriction. Here, however, the money was withheld for no reason other than such a practice is consistent with a short sale.

In spite of the voluminous evidence establishing and corroborating the short sales which were expressly incorporated in the findings of the Board of Tax Appeals, the Board made an inconsistent finding based upon the testimony of certain clerks in the broker's office (the margin clerk, dividend clerk, and stock clerk) that the taxpayer's long stock was delivered against short sales in all cases where long stock was available. There is no way of reconciling the testimony of these clerks, if it is taken at its face value, with the broker's records and the taxpayer's records, and the Board made no attempt to do so in its opinion. Indeed there is no way of reconciling such testimony with the results in *Henry B. duPont* v. *Commissioner, supra,* and *Henry F. duPont* v. *Commissioner, supra.* But if the testimony is construed in the light of the particular functions of these clerks, it does not mean that the taxpayer's long stock was actually delivered against her short sales and it is entirely consistent with the broker's records and

the taxpayer's records indicating that short sales were intended to be and actually were made.

Thus, Maxwell, the margin clerk, was interested in the taxpayer's *net* position in various stocks for margin purposes. His firm was expressly authorized to treat all the accounts as one for margin purposes. Therefore, from his point of view as margin clerk, he could truthfully testify that in all cases of short sales he looked first to see whether there was adequate stock in her long accounts (Tr. 565, 568, 569). At no time did he testify that the Customer's Ledger, Exhibit K (Tr. 228), showing the taxpayer's short position, was incorrect. Indeed he testified that he had no way of telling whose stock was being used to cover a short sale (Tr. 573). If the stock could not be identified because it was in "street names," the Board could not reasonably find that the taxpayer's long stock was delivered against short sales.

Wingate, the stock clerk, was obliged to keep the taxpayer's *net* position because his duty was to determine how much stock was owing to the broker from customer's correspondents and others, and how much stock was owed by the broker to customer's correspondents and others. But his records must have shown the taxpayer's actual position, that is, the number of shares short and the number of shares long. He too testified that his records did not show whose stock was borrowed for delivery against short sales. (Tr. 603.) He

did not testify that the Customer's Ledger, Exhibit K (Tr. 228), was incorrect.

Copeland, the dividend clerk, was concerned with the taxpayer's *net* position because it was his function to collect an amount equivalent to dividends on the broker's net holdings from the broker's correspondent in New York or to collect the dividends direct from the corporation. He did not testify that the Customer's Ledger, Exhibit K (Tr. 228), was incorrect or not in accordance with the facts.

In this connection the court below said (R. 88–89):

> Considering the statements of these men in the light of their duties, the findings are unsupported. The particular function of a stock-clerk must be appraised in weighing his testimony and if a customer's long account had sufficient number of shares, deliveries were made out of that stock. As a stock-clerk he was concerned only with the net position of the broker. From his testimony it cannot be said that the broker did not use borrowed stock to make deliveries on short sales. Nor can his testimony have any bearing upon taxpayer's intention other than through his admission that the sales were treated as short sales for bookkeeping purposes. A dividend-clerk testified that he collected dividends only on the amount that the long stock exceeded the short. His concern with taxpayer's net position was because it was his function to collect an

amount equivalent to dividends on the broker's net holdings from the broker's correspondent in New York, who in turn would collect dividends from the corporation. But this evidence does not refute the actual entries in the customer's ledger crediting dividends on the long accounts and charging dividends on the short. Nor can any more be said for the testimony of a margin-clerk who stated that none of the sales tickets bore the words "short sales." The absence of this designation is not determinative since it does not appear that sales concededly short were so labeled.

The decision of the court below that the short sales recorded in the broker's books were short sales is correct, and there is therefore no basis for petitioner's first ground for certiorari, namely, that the court below substituted its judgment of the facts for that of the Board contrary to the decisions of this Court.

2. Petitioner urges further that the court below refused to accept the Board's finding that the taxpayer was engaged in carrying on a trade or business within the meaning of Section 23 (a) of the Revenue Act of 1934. But the inference is plain from recent decisions of this Court that looking after one's investments, irrespective of their magnitude, does not constitute a trade or business within the meaning of the statute. Cf. *City Bank Co.* v. *Helvering,* 313 U. S. 121, 126; *United States*

v. *Pyne,* 313 U. S. 127, 132; *Higgins* v. *Commissioner,* 312 U. S. 212, 218.

3. Petitioner contends that the court below failed to "look through form to fact and substance" (Pet. 17–20). In regard to a particular stock, McKeesport Tin Plate, the petitioner argues that since taxpayer was long and short the same number of shares of stock during the taxable year, she did not in fact receive any taxable income from any dividends on that stock. The petitioner concedes that the broker's records and taxpayer's own books showed a credit of the amount of such dividends, although at the same time her short account was charged with a corresponding amount (Pet. 19). However, the amounts credited as dividends represented gross income within the meaning of Section 22 (a) of the Revenue Act of 1934 which expressly includes dividends within the definition of gross income. The Board found that the broker reported to the Treasury Department the amounts credited to the taxpayer as dividends (R. 7). The fact that she was charged with a corresponding amount of dividends on her short stock so that her net cash position in regard to dividends was zero affords her no reason for failing to report the dividends as gross income. She must take the consequences of the forms that she has adopted. See *Higgins* v. *Smith,* 308 U. S. 473, 477; *Gray* v. *Powell,* No. 18, this Term.

The Revenue Act requires that a taxpayer must first return his or her gross income, from which he or she may deduct certain definitely enumerated items in computing net income. Since dividends are expressly included within the definition of gross income in Section 22 (a) of the Revenue Act of 1934, the taxpayer was not excused from returning the dividends credited to her as income. There is no provision in the Act which permits her to make mental deductions from gross income and report only the difference in her return. This is true even though her entire income does not in fact represent a net gain or profit. See *Burnet v. Sanford & Brooks Co.*, 282 U. S. 359.

The petitioner argues that only the *net* number of shares was turned over to Laird & Company, considering only her net position in that security. (Pet. 18.) But the Stipulation of Facts (which is incorporated in the Board's findings) states that the regular, special, and short accounts were set up and restated on the books of Laird & Company "in the same, identical manner and amounts as theretofore in the books of Laird, Bissell & Meeds (Exhibits F, G, H and I, J, K)" (R. 29).

The petitioner argues that the broker did not have any McKeesport stock, which could have been delivered, while the taxpayer was credited with 6,650 shares in her long account (Pet. 19). There is no necessary relationship between the net position of a broker and the actual position of a

single customer. This apparent discrepancy could readily be explained by the existence of long accounts and short accounts of other customers in the same stock which resulted in the net position of the broker of only a few shares of stock. There is no reason why a broker could not borrow the long shares of another margin customer to deliver on the taxpayer's short account, and that is undoubtedly what was done (Tr. 573). Moreover, some of the stock in "street" names may have been placed as collateral for banker's loans, and there is no reference to the amount of stock placed as collateral—although the collateral is mentioned in the testimony (Tr. 616, 617, 634).

4. The petitioner does not assign any reason for granting the writ in regard to commissions paid on sales of securities and commodities,[4] although there is a Specification of Error in regard to the question (Pet. 11). The issue is whether the commissions were "ordinary and necessary" business expenses. But the court below has held that the taxpayer was not engaged in business, and, therefore, the question whether the expenses were "ordinary and necessary" does not even arise. Since the preliminary question has been decided against the taxpayer, the pendency of *Spreckels* v. *Helvering,* Nos. 581 and 582, this Term, cer-

[4] This may be due to the small amount of tax involved on this item. The commissions amount to about $2,300 for the year 1934, and to about $4,100 for the year 1935 (R. 33).

tiorari granted October 20, 1941, and *Covington v. Commissioner,* Nos. 693 and 694, this Term, does not afford a basis for granting the writ.

CONCLUSION

The case depends largely upon its peculiar facts. The decision of the court below is correct. There is no conflict of decisions upon any of the primary questions involved. The petition for certiorari should be denied.

Respectfully submitted.

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